UNDERSTANDING THE SOCIAL SECURITY DEBATE [*]

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A recent poll indicated that there is considerable confusion about the state and the fate of the Social Security system (NPR 1999). While most Americans are aware of Social Security's impending financial crisis, confusion over the dimensions of the program's problems appears to be undermining support for the measures required to resolve them. This Economic Letter reviews some of the basic facts about the U.S. Social Security system, describes how it is financed and the factors contributing to its future insolvency, and discusses options for restoring its financial health.

U.S. Social Security System

The Social Security program was enacted in 1935 in response to the economic hardships imposed by the Great Depression. While the original program paid benefits to a limited number of retired workers, numerous expansions have made Social Security the most comprehensive public program in the United States. Over 90% of American workers participate in the Social Security system, contributing payroll taxes in exchange for publicly provided retirement, disability, and survivors' insurance for themselves and their families. In addition to providing near universal, as well as portable and inflation-resistant, insurance against earnings loss, the Social Security program has a redistributive function that shores up the retirement incomes of life-time low earners, a feature not available in private pension plans.

Impact on Retirement Security

The Social Security program has dramatically improved the economic well-being of the elderly. Estimates suggest that when Social Security began close to 50% of the elderly lived in poverty. By 1959 the rate had fallen to 35%, but remained higher than that of other groups, including children and working-age adults. During the 1960s and early 1970s, Social Security benefits increased substantially and poverty rates among the elderly declined rapidly (Figure 1). By 1974, the poverty rate for elderly Americans had fallen below that for children, where it has remained since. In 1993 it fell below the rate for working-age adults. Today only 11% of the elderly have incomes below the federal poverty line.

Studies show that without income from Social Security, the poverty rate for the elderly would be much higher. The Social Security Administration estimates that 47% of individuals age 65 and older would live in poverty without Social Security benefits, four times as many as are in poverty today (SSA 1999). Social Security's poverty reducing record, along with its inclusiveness, have made Social Security one of the most popular social programs in history.

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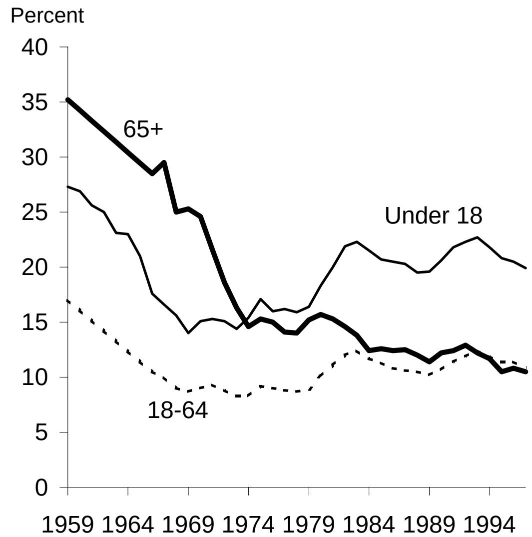
Figure 1
U.S. Poverty Rates



Social Security Financing

Although the language used to describe Social Security speaks of payroll contributions, retirement savings, and a trust fund, Social Security is unlike any private pension plan. Instead of investing workers' payroll tax contributions when they are young and allowing them to draw down the interest and principal during retirement, Social Security uses taxes from current workers to finance payments to current beneficiaries, a system known as pay-as-you-go. In the event that more Social Security taxes are paid in a year than are necessary to fund current beneficiaries, the Social Security Administration purchases special securities from the Treasury Department and holds them in the Social Security trust fund. The bonds in the trust fund earn interest equal to the average rate of return on publicly traded government debt; this interest is credited to the trust fund in the form of additional Treasury securities.

In 1998, the Social Security Administration collected $440 billion in taxes and paid $382 billion in benefits and administrative fees, generating a yearly surplus of $58 billion dollars to be invested in Treasury bonds. Interest earned on existing trust fund assets during 1998 totaled $49 billion, producing an overall annual surplus of $107 billion. With the addition of this surplus revenue, the Social Security trust fund closed 1998 with about $763 billion in assets.

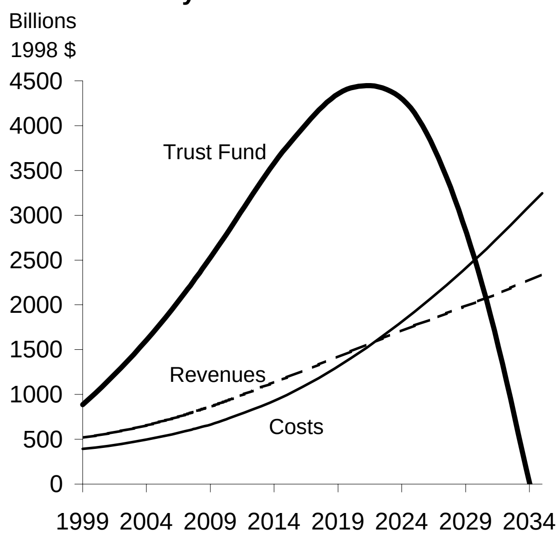
Long-term Financial Imbalance

Although Social Security currently is booking a surplus, collecting more taxes than it pays out in benefits, major demographic changes threaten to erode its solvency. Based on intermediate projections by actuaries at the Social Security Administration, benefit payments will outstrip tax revenues beginning in 2014. By about 2022, benefit payments will be larger than tax revenues plus interest from the trust fund, and Social Security will need to sell Treasury securities to generate sufficient revenue to pay claims. By 2034, the trust fund itself will be depleted and the Social Security system will depend completely on tax revenues, which are expected to cover 71% of outstanding claims (Figure 2).

The Trust Fund

Despite the fact that the Social Security trust fund is expected to last through 2034, the costs of the Social Security imbalance will be felt 20 years earlier, when the Social Security Administration begins to redeem its Treasury bonds. Under the unified budgeting system, surplus revenues given annually to the Treasury by Social Security in exchange for bonds are used to finance deficit spending by other areas of government. Some of these activities can be thought of as investments, such as transportation and education, but many others are pure consumption--transfer payments, for example. Either way, when payroll tax revenues no longer cover benefit claims in 2014, the Social Security Administration will turn to the Treasury, which will need to finance the interest and principal payments by borrowing from the public, reducing spending on other federal programs, or raising revenues. Taxpayers likely will feel the costs in the form of increased taxes or in the form of reduced resources for other activities.

Figure 2
Social Security Finances



Source: SSA, 1999

How Did This Happen?

The viability of pay-as-you-go financing schemes depends heavily on the size of the pool of taxpayers (workers) compared to the pool of beneficiaries (retirees). In 1935, when Social Security was conceived, there were roughly 16 workers for every beneficiary, more than enough to support a modest pay-as-you-go retirement program. Over time, program expansions and behavioral changes steadily reduced this ratio so that today there are just 3.3 workers per beneficiary. Shifting demographics will reduce the worker-to-beneficiary ratio further during the next 30 years. Official projections indicate that by 2030 there will be just 2 workers for every person collecting Social Security benefits.

A major contributor to the projected decline in the worker-to-beneficiary ratio is the rapidly approaching retirement of the baby boom generation. The oldest of the generation will reach retirement age (65) in 2011, and the youngest will reach it in 2029. The aging of such a large generation alone would strain the ability of the program to pay benefits, but the stress is compounded by the fact that a relatively small generation, the baby bust, follows, and subsequent fertility rates have remained low. As a result, the population of elderly as a share of the U.S. population is expected grow from 13% to 20% during the baby boom's retirement, an increase of 54%.

Exacerbating these population trends are increases in life expectancy and declines in the average retirement age. In 1950 life expectancy for males after age 65 was 12.8 years and the average retirement age was 69. Thus, for the average male retirement lasted about 9 years. Today, male life expectancy after age 65 is 15.7 years, and the average retirement age has fallen to 64, meaning that the average male will spend approximately 17 years in retirement, about twice as long as earlier recipients. Projections indicate that these trends in life expectancy and retirement will continue. In 2030 men who reach the age of 65 are expected to live an additional 17.3 years, and spend nearly one quarter of their lives in retirement.

Restoring Solvency

Although talk of reform dominates the current debate, Social Security's long-term financial balance can be restored without changing the program's basic structure. For example, the 75-year actuarial balance could be restored simply and quickly by raising the current payroll tax by 2.1 percentage points, from 12.4% to 14.5%. Revenues could also be increased by expanding the taxable payroll level on earnings, including nonwage compensation as covered earnings, and increasing the income taxation of Social Security benefits. On the other hand, expenditures could be reduced by eliminating or decreasing existing benefits, altering the benefit formula, increasing the normal and early retirement ages, limiting or removing cost-of-living adjustments on benefits, strengthening the earnings test, and imposing means-testing for benefits. (For estimates of the effects of each of these proposals, see GAO 1998.)

Measures like these have been used before (in 1982 for example), but polls indicate that currently there is little support for restoring Social Security's solvency by raising taxes or reducing benefits. Younger workers are reluctant to accept additional payroll taxes, particularly when they do not expect to receive Social Security benefits themselves; older workers are opposed to higher ages for retirement and means-testing benefits; and retirees do not want to see cost-of-living adjustments eliminated. The lack of consensus around these options has prompted unprecedented discussion of more basic reforms of the Social Security system.

Ideas for Reform

Investment diversification, privatization, and prefunding are three concepts receiving the attention of policymakers. Although many plans incorporate all three reforms, each could be implemented independently. Diversification refers to altering the investment strategy of Social Security, allowing funds to be invested in assets other than Treasury securities. The idea behind diversification is to take advantage of the historical return advantage of common stocks over other financial assets (see Lansing 1998 for a discussion of investment diversification). Privatization describes a system of personal retirement accounts that are owned and directed by participants. The key element of all privatization plans is that they award individuals greater investment freedom; in exchange, individuals take on the investment risk currently borne by the government. Prefunding involves saving privately issued assets (like corporate bonds and equities) to finance future claims against the system. Advance funding would make the Social Security system more like private retirement programs where each generation builds up assets sufficient to cover its future retirement costs.

Key to Success

Proposals for reforming Social Security abound and range from maintaining the current structure and tinkering with the investment strategy to dismantling Social Security altogether and privatizing retirement savings. The key to the success of any of these alternatives is early implementation. Each year that no action is taken shortens the number of years over which the costs are shared and shifts a larger portion of the costs to future generations.

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